IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH, *Plaintiff in Error*,

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF.

Filed, as *amici curiae*, with permission of the Court, by

T. P. GORE,
HOKE SMITH.

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This case involves the construction of the Sixteenth Amendment to the Constitution. It also involves the construction and the constitutionality of the Income Tax Act of 1916.

The Sixteenth Amendment reads as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

The Income Tax Act of 1916, reads in part as follows:

> "Sec. 1. (a) That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income; and a like tax shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources within the United states by every individual, a non-resident alien, including interest on bonds, notes, or other interest bearing obligations of residents, corporate or otherwise."

The Constitution of the United States, from the time of its adoption, has contained the following:

> "ARTICLE I, Section 2, clause 3. Direct taxes shall be apportioned among the several states which may be included within this Union, accord-to their respective numbers * * *"
>
> "ARTICLE I, Section 9, Clause 4. No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration, hereinbefore directed to be taken."

It requires no argument to show that the Tax Act of 1916 is in conflict with these provisions of the Constitution, unless it is saved by the Sixteenth Amendment.

Pollock vs. Farmers Loan and Trust Co. 157 U. S. 429 and 158 U. S., 601.

We became interested in this cause after the oral argument was commenced but before the Solicitor General had ~~considered~~ conceded in his argument that certain of the taxes protested in these two cases were invalid and therefore improperly levied and collected. This accounts, of course, for the absence herein of any further reference to those particular assessments.

THE SIXTEENTH AMENDMENT DOES NOT ENLARGE, AND WAS NOT INTENDED TO ENLARGE, THE TAXING POWER OF CONGRESS.

The power of Congress to lay and collect taxes is plenary with but one exception and with but two qualifications. One of the qualifications requires that direct taxes shall be levied in accordance with the rule of apportionment. The other qualification requires that indirect taxes (duties, imposts and excises) shall be levied in accordance with the rule of uniformity.

The Sixteenth Amendment does not enlarge and was not intended to enlarge the taxing power of Congress. It brings no new subject and no new object of taxation within the power of Congress. It does not alter the extent of the taxing power, it merely changes the method of exercising that power with respect to incomes arising from real and personal property.

Before the adoption of the Sixteenth Amendment, Congress could tax real and personal property only by the rule of apportionment. Since the adoption of the Sixteenth Amendment, Congress can tax real and personal property only with the rule of apportionment, but it can tax incomes arising from real and personal property without reference to the rule of apportionment.

THE SIXTEENTH AMENDMENT DID NOT CHANGE THE CHARACTER OF THE THING "INCOME."

The Sixteenth Amendment did not change and did not undertake to change the essential nature or character of the Thing "income." It did not change and did not undertake to change the definition of the word "income." Whatever could be taxed only in accordance with the rule of apportionment before the ratification of the Sixteenth Amendment can still be taxed only in accordance with that rule,—excepting incomes arising from real and personal property.

So far as direct taxes and the rule of apportionment were concerned prior to the Sixteenth Amendment, all taxes fell within two categories: taxes on property and taxes on incomes arising from personal property as such, or taxes on incomes arising from real and personal property.

Direct taxes in the first category, direct taxes on real and personal property must still be laid in accordance with the rule of apportionment notwithstanding the Amendment. Direct taxes in the second category, direct taxes on incomes arising from real and personal property, by virtue of the Amendment, can be laid without reference to the rule of apportionment.

WHAT IS INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

This brings us to the controlling question in the case. What is income? What things does the word include as used in the Amendment, and what things does it exclude?

Does the word "income" as used in the Sixteenth Amendment include, and was it intended to include, accretion to capital, unearned increment or gains derived from the profitable sale of capital assets? The answer to this question decides the case.

When the Congress submitted,—when the States ratified the Sixteenth Amendment, did they intend to withdraw from the rule of apportionment all increase of value in real and personal property and subject such increase to direct taxation without reference to such rule? It should be borne in mind that the question is not whether unearned increment, whether incomes of capital values are taxable or non-taxable, but whether they are taxable in accordance with the rule of apportionment or without reference to such rule.

It some times serves to illuminate and to determine the correctness or incorrectness of a theory to consider its necessary implication, and its logical conclusions. The aggregate wealth of the United States on March 1, 1913, was approximately $200,000,000,000. The aggregate wealth of the United States today is approximately $300,000,000,000. Here is an increase of $100,000,000,000. A large part of this represents unearned increment; represents the increase of capital values in the hands of the self-same owners who held this property on March 1, 1913. According to the theory of the governmet, all this increase of capital values is liable to be taxed as income when realized

or when converted into cash. All the real and personal property in the United States was commuted or crystalized into capital as of March 1, 1913, by the Act of 1916. All increase in the value of such property since that date is constituted and denominated income; is classified, characterized and defined as income of those who owned it on that date. All unearned increment, all increase in the value of personal and real property acquired since March 1, 1913 *or acquired subsequent to the present hour*, will according to the theory of the government, automatically come within the category of income the moment it is sold, and will be subject to a direct tax without apportionment.

Again, when it is remembered that the normal tax is 8 per cent, and when the income exceeds $100,000 a fifty-two per cent surtax is added, and these taxes increase rapidly until they reach seventy-three per cent, it will be seen that the construction urged as to the Sixteenth Amendment practically wipes out the security and protection for which the States stipulated in respect to direct taxes at the time of the adoption of the Constitution.

THE GOVERNMENT UNDERTAKES TO MEASURE THE INCREASE IN VALUE BY MONEY, WHICH HAS, ITSELF, DEPRECIATED IN VALUE.

The Government undertakes to fix the increase in the value of investments by the money for which it was sold during the year of the assessment, less the market price in 1913, and this is to be done without reference to whether money has itself depreciated in value, having lost much of its purchasing power. To illustrate: Between March 1, 1913, and June 1, 1920,

the price at which an investment could have been sold might have increased fifty per cent and yet the money so received might have decreased in purchasing power to the same extent. An investor whose property in 1913 would have brought $100,000 might have sold it in January, 1920, for $150,000, and, under this proposed assessment, he would have been compelled to pay a large income tax. With the amount left him he could not have purchased those commodities which could have been purchased in 1913 for $100,000, purchasing power of his capital not having increased.

A SALE CAN NOT CHANGE INCREASED VALUE OF INVESTMENTS FROM CAPITAL TO INCOME.

The following question should be considered and decided at this point: When does unearned increment, when does such increase of capital values become "income?" Is it income the moment it accrues in the hands of the owner; or does it assume the character of income only the moment it is realized or sold by the owner? If it is income the moment it accrues in the hands of the owner, then it is subject to a direct tax as such within his hands to the same extent as when realized by sale. If it is not income so long as it remains in his hands unsold, then it must be capital. But would the mere sale of capital change its essential character from capital to income? We insist that this unearned increment, this increase of value, is the same in its essential character before and after sale. Sale could not change the essence of the thing. This unearned increment, this increase of value must of necessity fall in one or the other of these two categories: It must be capital, or it must be income.

If the contention of the Government be well founded that this unearned increment, that this increase of capital value is income the moment after it is sold, can the conclusion be resisted that it was likewise income the moment before it was sold? If it was income, and not capital prior to the sale, then it would be subject to a direct tax under the Sixteenth Amendment without apportionment. There is but one escape from this conclusion, and that is, the mere act of sale converts a thing, which in its nature is capital, into a different thing which in its nature is income.

ILLUSTRATIONS GIVING THEORY, IN RELIEF.

A double illustration may here serve to present our theory in relief. (1) A, whose business is buying and selling property, purchased on March 1, 1913, among other pieces of property, a manufacturing establishment at a price of $100,000. He sold it two days later at a profit of $5,000. This would undoubtedly be income, determined by the character and circumstances of his business. (2) B, who is a manufacturer, purchased a similar manufacturing establishment on March 1, 1913, at a price of $100,000. He operated the plant until the summer of 1918. He made no improvements, but merely maintained the property intact. He sold it in the summer of 1918 for $200,000. Was this increase of $100,000 income, or was it an advance in the value of his capital? However that question may be decided, it certainly was, in one sense, his capital. It was his entire capital. It was exactly the same plant which he had purchased, it was in all parts essential to the conduct of his business, it had exactly the same capacity as on the day of its purchase and was

suited to exactly the same needs and requirements and no more. Let us assume, however, that the Government's theory was correct, and that this $100,000 was income and not capital, and that he was required to pay—let us say—an income tax of $40,000 upon the realized profit. Now let us assume that three months later, B decides to re-enter the manufacturing business. He obtains a price on the plant which he had sold three months before. The price is the same that he received, $200,000. But he has only $160,000 of the proceeds with which to rebuy this identical plant. This plant is undoubtedly capital in the hands of the party who purchased from B. He required the entire plant and the equipment for the conduct of his business. If B should re-purchase it, it would be capital in his hands. It would simply be the replacement of his capital. Was the $100,000 advance in the value of the plant, capital, or income? If it was capital in the hands of B., prior to the sale; and if the same property is capital when received by the purchaser, how can it be said that $100,000 of the amount received by B. was capital and $100,000 income and subject to tax?

A man has owned a farm for a number of years. The farm is his capital. Farm land has increased greatly in value. He wishes to sell his farm and buy another farm of equal value. If the theory of the Government prevails his capital will be so reduced the purchase can not be made.

A man owning a store may conclude to change his place of business. The property in the place of his business has increased substantially in value since his purchase. His store property is largely his capital; he sells it, and if the income tax is taken out of his

increase he can not buy a place of similar value in his community, because the income tax taken from the increased value of his capital would leave him not sufficient with which to buy the other property. It would simply destroy the privilege of changing capital from one investment to another.

CONGRESS AND THE STATES DID NOT INTEND TO SUBJECT INCREASE IN VALUE OF CAPITAL TO A TAX AS INCOME.

Did Congress intend, and did the several states intend, to render such an advance in the value of capital subject to a direct tax as income without apportionment? To answer this question, the Court should assume the point of view of the Congress when the Sixteenth Amendment was submitted, and to assume the point of view of the several states at the time this Amendment was ratified. The Court should consider the historic background, the judicial precedents, and all other circumstances which acted upon and influenced the Congress and to which the Congress reacted in the consideration of the proposed Amendment.

In *Eisner vs. Macomber*, 252 U. S., 189, Mr. Justice Pitney points out the occasion for the adoption of the Sixteenth Amendment and the necessity which requires that it shall not be extended by loose construction.

In that decision he says:

> "The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution, and the effect attributed to them before the amendment was adopted. In in-

come tax cases under the Act of August 27, 1894, it was held that taxes upon rents and profits of real estate, and upon returns from investments of personal property, were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership, and that Congress could not impose such taxes without apportioning them among the states according to population as required by Article I, Section 2, cl. 3, and Section 9, cl. 4, of the original Constitution.

"Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted in words lucidly expressing the object to be accomplished. * * * As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income.

(Citing authorities.)

"A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population of direct taxes upon property real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts."

The court is therefore, called upon to construe the Sixteenth Amendment, and to determine the extent to which the authority therein given Congress "to lay and collect taxes on income from whatever source derived" removes the original constitutional requirement that direct taxes shall be apportioned among the states according to population.

What was the general and ordinarily accepted meaning of the word "income" in 1909 when Congress submitted the Sixteenth Amendment to the states? And what was the generally and ordinarily accepted meaning of the term at that date and when in 1913 the amendment was ratified by the Legislatures of the States?

> "In the construction of the language of the Constitution * * * we are to place ourselves as nearly as possible in the condition of the men who framed that instrument." (*Ex parte Bain*, 121 U. S., 12) and "that which it meant when adopted, it means now." (*South Carolina vs. U. S.*, 199 U. S., 448.)

THE SIXTEENTH AMENDMENT WAS FRAMED AND ADOPTED, RELYING ON GRAY VS. DARLINGTON.

No responsibility placed upon Congress is greater than that of preparing an amendment to the Constitution, and the language used is, of course, subjected to the most thorough scrutiny.

A constitutional amendment is each House is referred to the Judiciary Committee, and we may accept it as true that the language of a proposed constitutional amendment receives the most careful consideration.

When considering the terms of a proposed amendment, the first luminary to which Congress turns for light and guidance is the Supreme Court of the United States. Congress through the Sixteenth Amendment was seeking to meet the decision of the Supreme Court in the Pollock case, and to subject not capital in any form, but incomes to taxation without appor-

tionment and the Congress was selecting language to carry out this purpose.

Turning to the decisions of the Supreme Court, Congress had before them the leading case on the subject, the celebrated case of *Gray vs. Darlington*, 15 Wallace, 63. In that case it had been expressly declared that increases in the value of investments, extending over a period of years, constituted capital, and did not constitute income. This decision was rendered by the Supreme Court in 1872. It had never been overruled. Its soundness had never been questioned. It enabled Congress to use, in the Sixteenth Amendment, the words, "income from whatever source derived," with the definite knowledge that these words would not take away from the increased value of investments, sold or unsold, its status as capital, and would not subject it to taxation without apportionment.

In *Gray vs. Darlington*, the Court was ruling upon the income tax act of 1867. This act provided "that there shall be levied, collected and paid, annually upon the gains, profits or income of every person residing in the United States whether derived from any kind of property, rents, interest, dividends or salaries or from any profession, trade, employment, or vocation, carried on in the United States or elsewhere, or from any other source whatever," a tax of five per cent. The act further provided (Sec. 117) that the tax should apply to "all other gains, profits, or income *derived from any source whatever*." It further provided that the tax should be "assessed, collected and paid, upon the gains, profits or income for the year ending on the thirty-first day of December next pre-

ceding the time for levying, collecting and paying said tax."

In *Gray vs. Darlington,* the plaintiff was the owner in 1865, of certain treasury notes which he exchanged for United States bonds, and in 1869, the year the tax was assessed, he sold these bonds at an advance of $20,000.00. He realized the increased value of his investment by turning it into money the year the tax was assessed. It was the increased value of his investment turned into cash, and "derived" by him the year of the assessment, which the Government sought to tax as income.

The Court held this increased value of investment, turned into cash by the sale of the investment during the particular year, was not gains, profits or income derived from the property during that year, and decided that the sale of the investment at an advanced price did not change capital to income.

In *Gray vs. Darlington,* Mr. Justice Fuller, delivering the opinion of the Court declared on page 66:

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. *It constitutes and can be treated merely as increase of capital."*

We repeat: the bonds in this case were sold; the taxpayer changed his investment from bonds into money; there was an increase of $20,000 which he received in excess of what he paid. The act of 1867 taxes "all other gains, profits, or income derived from any source whatever." The Supreme Court ruled that this in-

crease in the value of the investment, though the investment was sold and money received from it during the year of the assessment "constitutes and can be treated merely as increase of capital."

THE SIXTEENTH AMENDMENT DOES NOT ENLARGE THE MEANING OF THE WORDS AS USED IN THE ACT OF 1867.

When the Sixteenth Amendment was passed by Congress there was no enlargement of the meaning of the words used, from those used in the act of 1867. In the act, the language used was: "income derived from any source whatever;" in the amendment, the language was "income from whatever source derived." *The Congress knew that this language did not extend to the increased value of investments, because the Supreme Court had so decided.* They safely used the language without fear that they were removing the increased value of investments from the constitutional safeguard of being free from direct tax unless apportioned.

In *Lynch vs. Turrish,* 247 U. S., 221, the Court followed *Gray v. Darlington,* and quoting from that case among other things said (p. 230):

> "This case has not been since questioned or modified.
>
> "The Government feels the impediment of the case and attempts to confine its ruling to the exact letter of the Act of March 2, 1867, and thereby distinguish that Act from the Act of 1913, and give to the latter something of retrospective effect. Opposed to this there is a presumption, resistless except against an intention imperatively clear. The Government, however, makes its view depend

upon disputable differences between certain words of the two acts. It urges that the Act of 1913 makes the income taxed one "arising or accruing" in the preceding calendar year, while the Act of 1867 makes the income one "derived." Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of *Gray vs. Darlington,* which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as "arising or accruing," to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. *Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."* (Italics ours.)

We must believe that the language of the Sixteenth Amendment was used by Congress with full knowledge of the principle decided in *Gray* vs. *Darlington,* and with the intent not to tax as income increased value of investment sold or unsold.

ENGLISH INCOME TAX ACTS AND DECISIONS.

Prior to the adoption of the Sixteenth Amendment, the English courts had definitely decided that the profits derived from the sale of capital investments at an advance over cost was still capital and did not produce income. The English Income Tax Act of 1853 levied an income tax: "For and in respect of the annual profits or gains arising or accruing to any per-

son residing in the United Kingdom from any kind of property whatever whether situate in the United Kingdom or elsewhere and for and in respect of the annual profits arising or accruing to any person residing in the United Kingdom from any profession, trade, employment or vocation, whether the same shall be respectively carried on in the United Kingdom or elsewhere to be charged for every 20 shillings of the annual amount on such profits or gains," 7 pence, etc.

16th and 17th Victoria, Great Britain Public General Statutes 1852-53, sec. 34, page 262.

During a long period of years the courts of England have held that the increase in value of investments, even though realized by sale, was still capital assets and not taxable as income under their income tax laws, and when, in England, there was no constitutional limitation.

In the case of *California Copper Syndicate, Ltd. vs. Harris*, (1904 Echequer Scotland) 5 Tax Cases 159, Lord Justice Clerk stated the rule as follows:

"It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of invest-

ment, but an act done in what is truly the carrying on, or carrying out, of a business."

So far as the question involved is concerned the Act of 1842 does not differ from the Act of 1852.

In *Taxation Commissioners vs. Mooney* (1907 Privy Council), A. C., 342, 360, Lord Macnaughten, delivering the opinion, stated:

> "A change in the form of property by a person who does not traffic in that kind of property, can not be regarded as producing income taxable under the Income Tax Acts."

In the case of *Hudson's Bay Co. Ltd. vs. Stevens* (1909 Court of Appeals), 5 Tax cases, 424, 436, 437, 440, Lord Justice Farwell said:

> "It is well settled that income, not capital, is taxable under the Income Tax Acts. * * * It is clear, therefore, that a man who sells his land, or pictures, or jewels, is not chargeable with income tax on the purchase-money or on the difference between the amount that he gave and the amount that he received for them. But if instead of dealing with his property as owner he embarks on a trade, then he becomes liable to pay, not on the excess of sale prices over purchase prices, but on the annual profits or gains arising from such trade, in ascertaining which those prices will no doubt come into consideration."

In the case of the *Tebrau (Johore) Rubber Syndicate Ltd. vs. Farmer* (1910 Exchequer, Scotland), 5 Tax Cases 658, 664-5, Lord Salvesen stated:

> "I am unable to distinguish the position of the Appellants from that of a person who acquires

> a property by way of investment and who realizes it afterwards at a profit. It is well settled that in such a case the profit is not part of the person's annual income liable to be assessed for income tax, but results from an appreciation of his capital."

From these decisions it is clear that the Courts of Great Britain in considering their income tax laws drew the distinction between a trader and an investor, and held that, if the sale was by a trader in the course of his business, the profit would be income and taxable; but, if the sale was of a capital investment made at a price in advance of the cost, the proceeds were capital and not income. In the *Californian Copper case* (*supra*), 5 Tax Cases, 166, Lord Justice Clerk said:

> "The question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit making?"

The same rule of construction has been adopted in Canada, Australia and South Africa.

Their courts have followed the rule that the proceeds of property sold are prima facie capital, and not income, and that the term income does not include the difference of the cost of the property, and the price at which it is afterwards sold, unless the buying and selling of such property is the ordinary business of the person alleged to be a tax payer.

Pontifex's Canadian Income Tax, 23;
Bedell's Australasian Judicial Dict., 76;
Barnes Income Tax Practice in South Africa, 137-140.

See, also, to the same effect as the British decisions quoted, the following:

Assets Co. Ltd. v. Forbes, 3 Tax Cases, 542, 548
Scoble v. Secretary of State for India, A. C. 299, affirming 1 K. B., 494.
Commissioners of Taxes v. Melbourne Trust Ltd., A. C. 1001, 1010;
Webb v. Australian Deposit Bk., Ltd., 11 Commonwealth Law Rep., 223, 227;
McLachlan vs. Commissioner of Taxes, South Australian Law Reports, 138;
Bohemian Club vs. Acting Commissioner, 24 Commonwealth Law Reports, 334;
Shiels vs. Commissioner of Taxes, South Australian Law Reports, 175;
Commissioner of Taxes vs. Booyesen's Estate Ltd., South African Law Reports, 1918, App Div. 576;
Northern Assurance Co. vs. Russell, 2 Tax Cases 577;
Scottish Investment Co. vs. Forbes, 3 T. C., 231.

THE DECISIONS BY THE STATE COURTS SHOW THAT INCREASE IN VALUE OF INVESTMENTS IS NOT CHANGED FROM CAPITAL TO INCOME BY SALE.

The distinction between income and capital which we have been urging has been recognized in nearly every state in the Union. We do not insist that the Congress would be expected to be familiar with all these cases, but we do urge that their general effect was known, and especially was it understood in the states when the Sixteenth Amendment was ratified. And when Congress and the states used the words in the Sixteenth Amendment "income from whatever source derived" it is to be presumed that they possessed

knowledge of the meaning attributed to these words by the decisions of the various courts.

Over and over again in the states has it been held that the gains realized from the sale of capital assets held in trust for the benefit of a tenant for life were principal, and that the life tenant, entitled to the income of the fund, could not receive any part of the advance in value realized by the sale of invested capital. This gain having been uniformly treated as an increment to principal, a part of the capital and not income.

These decisions established a definite meaning for the word "income."

In the Cyclopedia of Law and Procedure (39 Cyc., 444), the following rule is laid down:

> "As instruments creating trusts frequently provide for the payment of income to one set of beneficiaries, and the corpus to another set, it often becomes necessary to decide what is included within the term 'capital,' and what within 'income.' In general, the capital or corpus of the trust estate includes not only the property which originally comes into the trustee's hands, but its increase in value and whatever subsequently takes its place and represents it; hence, it includes the money, including the profits, derived from a sale of stock, bonds, or other property of the trust estate."

Many conveyances in trust have been made from which the life tenant was to receive the income from the investment, and the remainderman the capital, on the death of the life tenant. Under these circumstances the question has arisen as to what is income, and the courts have held that the sale of the property

by the trustee for an advance price is not income, and does not go to the life tenant in the absence of some specific provisions in the deed of trust giving it to him.

In a case of this kind (*ex parte Humbird* 114 Md., 627), the court says:

> "The fact that as here the property may have been unproductive of income does not affect the ownership of its augmented value. This consideration might influence its purchase or retention as an investment, but would not change from corpus to income any part of the fund realized from its sale."

In *Parker vs. Johnson*, 37 N. J. Eq., 366, the original investment was increased and sold for an advanced price. Was the life tenant entitled to this advance as income, or did it become part of the capital? It was held that the increase derived from the sale must be reinvested as capital, and not distributed as income.

The court stated:

> "The profit is not income. It was made by the trustee in the process of converting the investment, and like a premium realized on the sale of Government Bonds in which the funds might be invested, it belongs to the fund."

In the sale of bonds it has been universally recognized that the increased value received belongs to the capital of the trust estate, going to the remainderman is not distributed to the life tenant as income.

Re Graham's Estate, 198 (Pa.) St. 216;
Matter of Gerry, 103, N. Y., 445;
Devenney v. Devenney, 74 O. St. 96 (77 N. E., 688);
Whittingham v. Scofield's Trustee, 67 S. W., 846 (Ky.).

In *Smith v. Hooper*, 95 Md., 16, the Supreme Court of Maryland said:

> "The word 'income' is not synonymous with increase. The value of stock may be increased by good management, prospects of business and the like, but such increase is not income. The conversion of some of the shares into money resulted merely in substituting the cash received for the shares thus sold, and if the unsold shares, represented nothing but capital though capital of largely increased value, the money obtained for the shares when sold can represent nothing but capital either."

(See also to the same effect as cases cited 103 N. Y., 445, *Matter of Gerry.*

Graham's Estate, 198 Pa. St., 216;
Lauman v. Foster, 157 Ia., 275;
Slocum v. Ames, 19 R. I., 409;
Carpenter v. Perkins, 83 Conn., 11;
Guthrie Trustees v. Akers, 157 Ky., 649;
Devenney v. Devenney, 74 O. St., 96;
Jordan v. Trust Estate of Jordan, 111 (Me.) 124;
Bankhead v. Mulholland, 85 S. O. (Miss.) 111.

CONGRESS COULD NOT HAVE INTENDED THE SIXTEENTH AMENDMENT TO TAX AS INCOME INCREASED VALUE OF INVESTMENTS, AND WITH SUCH A PROVISION, THE AMENDMENT WOULD PROBABLY NOT HAVE BEEN RATIFIED.

The history of our own tax legislation and the terms therein used may well have been within the congressional mind when the income amendment was passed. And if so, it simply fortifies the view that

the language used was intended to restrict, not broaden, the accepted definition of "income." The tax act of 1861 limited the levy to "income." The tax act of 1862 and 1864 broadened the phrase to "gains, profits or income." The tax act of 1865 changed this phrase to "gains, profits and income." The addition of these words "gains" and "profits" must have been thought to broaden the scope and effect of the statute. When the constitutional amendment was adopted by Congress, the constitutional amendment went back to the simple word "income" with the evident intention of limiting rather than broadening its effect.

We have shown that at the time Congress passed and submitted to the States the Sixteenth Amendment the Supreme Court of the United States, the courts of many of the States, the courts of Great Britain, and the courts of her Colonies and the Dominions, had all decided that increased value of investment was capital, and that sale did not change the increased value from capital to income. It is impossible to conceive that Congress was not reasonably familiar with these decisions. It is impossible to conceive that when the words "Income from whatever source derived" were used, Congress did not know that these words had been uniformly held not to cover increased value of investment sold or unsold.

It is impossible to conceive that Congress intended by the Sixteenth Amendment to take increased value of income sold or unsold, from the constitutional requirement that, when taxed, it should be by apportionment.

If they had intended this amendment to take increased value of investments or capital out from un-

der the constitutional rule of apportionment, how easily they could have added to the words "income from whatever source derived," the words, "which shall include increase in value of capital investments." But if this language had been used, and Congress had been brought face to face with the fact that it was proposed to tax for all time to come, increased value of investments or capital, without apportionment, does anyone doubt that Congress would have rejected the amendment? Going one step further: if the amendment had been so written, does anyone believe three-fourths of the States would have ratified it?

The states had always been jealous of conceding the power of taxation to the federal government. Under the articles of confederation, the federal government had no powers of taxation. The Congress submitted to the States two different amendments empowering the federal Congress to levy taxes. Both amendments failed. The clause in the Constitution in regard to the apportionment of direct taxes, etc., was one of the three compromises essential to the adoption of the Constitution itself. The proper rule of construction in this case would seem to be that the Sixteenth Amendment should be strictly construed as respects the federal government and the power conferred, and should be liberally construed as respects the state governments and the power retained. If the Brief of the Solicitor General in this case had been presented to the Congress and the several state legislatures as an argument in behalf of the Sixteenth Amendment might it not have reversed all the history of the action?

THE EXCISE TAX ACT OF 1909 PLACES A TAX UPON CORPORATE ACTIVITIES.

The Solicitor General seeks to escape the force of the construction given to income "from whatever source derived" in the Sixteenth Amendment by decisions of the Court applicable alone to the excise tax act.

No question arose in these cases as to the power of Congress to tax incomes as distinguished from capital. The excise tax was levied upon doing business in a corporate capacity. The advantage of corporate existence influenced the legislation and the gains from corporate activities arising from these advantages were to be taxed. In *Anderson vs. 42 Broadway Company*, 239 U. S., 69-72, the Court said:

> "The act of 1909 was not in any proper sense an income tax law nor intended as such, but was an excise upon the conduct of business in a corporate capacity; the tax being measured by reference to the income, in a manner prescribed by the act itself."

In *Doyle vs. Mitchell Bros.*, 247 U. S. 179, the Court said the tax was imposed:

> "Not upon the franchises of the corporation irrespective of their use in business nor upon the property of the corporation, but in the doing of corporate or insurance business and with respect to the carrying on thereof."

In the same case the Court further said:

> "An examination of these and other provisions of the act makes it plain that the legislative pur-

pose was not to tax property as such or the mere conversion of property, but to tax the conduct of the business of corporations organized for profit by a measure based upon the gainful returns from their business operations and property from the time the act took effect. * * * "Selling for profit is too familiar *a business transaction* to permit us to suppose that it was intended to be omitted from consideration in an act for *taxing the doing of business in corporate form* upon the basis of the income received "from all sources."

In the case of *Hayes vs. Gauley Mountain Coal Company*, 247 U. S. 189, the Court said:

"Since a conversion of capital often results in gain, the general purpose of the Act of 1909 to measure the tax by the increase arising from corporate activities, together with the income from invested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as gross income."

These decisions were all placed upon the ground that the tax was an excise tax upon corporate activities. It can not be claimed that they turned in any way upon the construction of the word "income," as it is used in the Sixteenth Amendment, or that they in any way held the increased value of investment sold or unsold under ordinary circumstances would be regarded as income rather than capital. And as late as the October term, 1917, the Court said in *Lynch vs. Turrish*, 247 U. S. 230, referring to *Gray vs. Darlington*:

"This case has not been since questioned or modified."

And further said:

> "Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

STATE INCOME TAX LAWS.

Counsel for the Government contends that in framing the state income laws it has been customary to include the increased value of investments when sold, and to subject them to taxation.

A somewhat careful examination of state statutes has enabled us to find no state income tax law which has been held to extend to the increased value of investments, except where the Act expressly included increased value of investments. Where it was the legislative intent to cover not only that which we have contended was income, but also to reach increased value of investments which we contend is capital, the purpose of so extending the rule has been set out specifically in the state statutes, and it has been deemed by their authors necessary to clearly declare in the statutes that the increased value of investments were to be subject to the tax.

Instead of this line of legislative enactments being of aid to the Government in support of its contention, they are definite evidence of the fact that state Legislatures have not understood the word "income" to apply to increases in the value of capital, whether sold or unsold.

When we sent to the Legislatures the Sixteenth Amendment they saw it used only the term "income." It did not provide that the word "income" should extend to the increased value of capital. As in their

own acts, they specify increased value of investments for tax if it was intended it should be taxed, when the Sixteenth Amendment reached them without any such specification, they naturally understood it did not apply to increased value of investments.

THE DEPARTMENT SHOULD NOT CONSTRUE THE INCOME TAX ACT OF 1916 TO LEVY A TAX UPON THE GROWTH OF INCREMENT IN VALUE OF CAPITAL ASSETS WHEN REALIZED BY SALE.

We do not insist that the language of the income tax act of 1916 is clear. It contains conflicting provisions. We have already undertaken to show that if the tax act of 1916 should be construed to levy the tax upon the growth of increment in value of capital assets when realized by sale, the act would be unconstitutional.

The act of 1913 did not tax realized increment. In the briefs of counsel, the contention is elaborately and ably presented that the Revenue act of 1913 did not tax realized increment of value, and that the changes in phraseology in the act of 1916 do not indicate any intent so to broaden the scope of income taxes as to construe realized increment as an item of taxable income.

The statute under consideration levies a tax on incomes, etc. It then defines "income" to consist of gains, profits and income. If the words "gains" and "profits," and the other words used, be construed to come within the boundary of the word "income," they are harmless, as they are useless. But if they be construed to have a wider significance or to include something more than income, then they collide with the Constitution and the law must fall.

The law in question can be harmonized with the Constitution, with the precedents of this Court, with the understanding of the Congress at the time the Sixteenth Amendment was adopted, by placing upon the word "income" the interpretation given to it in the case of *Gray vs. Darlington,* and by holding that the word "income" as used in the statute, does not include unearned increment, increase of capital value or profits arising from the sale of capital assets in isolated transactions.

The economic character and effect of a tax has no bearing upon its constitutionality. A constitutional tax may be uneconomic. And what might be an economic tax may be unconstitutional. It is our contention that this tax, as administered by the Department, and as applied to the profitable sales of capital assets, is both unconstitutional and uneconomic. It has done more to freeze free capital in the hands of its owners than any other law, past or present. It has done more to penalize business and to place brakes on the wheels of commerce than any other fiscal experiment in the annals of this country.

WHAT DID CONGRESS AND THE STATES INTEND THE WORDS "INCOME FROM WHATEVER SOURCE DERIVED," IN THE SIXTEENTH AMENDMENT, TO MEAN?

We have called attention to the history of the amendment; to the legislative enactments; to the judicial precedents. These are the lights which the Congress consulted for its guidance. Shall we conclude that Congress intended to regard or to disregard the judgment of this court in *Gray vs. Darlington?* That it intended to regard or to disregard the long line of

English decisions to the same effect? That it intended to regard or to disregard the practically uniform precedents that the increase in the value of a trust estate was capital and not income?

From what facts, from what authority, could Congress have arrived at the conviction that an advance in the value of capital realized in an isolated transaction was to be taxed as income and not treated as capital? When this court places itself in the point of view, and in the point of time occupied by Congress when the Sixteenth Amendment was submitted; if it follows its own decisions, if it follows the decisions of the English-speaking courts everywhere, if it follows judicial precedents and analogies, must it not reach the conclusion that, by this amendment it was intended that an increase in capital assets should only be treated as capital and not taxed as income?

T. P. GORE,
HOKE SMITH.

Washington, D. C., March 17, 1921.